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The Six Critical Components of Strong Municipal Management:

Managerial Methods to Promote Credit Enhancement

Summary

Municipal credit ratings do not generally peak in boom times and fall in recessions. One of the main factors behind this stability is the proven ability of governmental managers to implement strategies that maintain credit strength over the long-term. A strong governmental management team prepares well for economic downturns, maintains strong controls during boom times, and manages well during all economic cycles. To this point, strong management is a reason behind the fact that, even in the economic difficulties of calendar year 2003, the rate of upgrades exceeded downgrades by a factor of 270 to 144.

The five key factors Moody's assesses in determining a credit rating are: debt, finances, the debt's legal security, economy/demographics, and management strategies. Assessing managerial strength is the most subjective of our five rating factors, yet it is also essential. This special comment will address the most critical components that public managers can utilize to position their governments better for the short- and long-term, for maximum credit stability or improvement.

The six critical components of strong management are:

1. **Conservative budgeting techniques**
   A careful, organizational approach to budgeting that ideally involves conservative fiscal policies and multi-year modeling.
2. **Fund balance policies**
   Adoption of a clearly delineated fiscal plan which includes a fund balance target level and the instances in which reserves may be used.
3. **Debt planning**
   A formalized debt plan that includes target and maximum debt levels, targets for pay-as-you-go funding of capital work, and incorporation of these debt policies into a multi-year capital plan.
4. **Succession and contingency planning**
   A formalized succession/contingency plan which typically includes written documentation of organizational structures, succession plans should key personnel change, and specific scenarios to respond to likely changes that might affect credit.
5. **Strategic planning for economic development**
   Feasible economic development plans that suit the particular strengths and needs of the community, with clear guidelines that detail allowable incentives.
6. **Timely disclosure**
   Timely audited financial documents that are attested to by an outside firm, and the direct disclosure of any material events as soon as possible.

1. GOOD BUDGETING

Moody's recommended approach incorporates conservative budgeting and allows for contingency planning and mid-year flexibility. Specifically, we recommend: conservative revenue forecasting, tight expenditure controls and multi-year budget planning.

Conservative Revenue Forecasting

Moody's seeks to understand the many variables used to create robust budgeted revenue projections. We also prefer to see governments that work with information that is updated on a regular basis. For instance, Moody's analysts anticipate that feasible property tax revenue projections will be based on historic trends and include reasonable assumptions about the future of the local real estate market, the direction of national interest rates, and the local government's likely tax collection rate. Similarly, sales tax revenue projections might incorporate recent actual trends and indicators of likely future purchasing demand – such as population trend numbers, expected unemployment rates and the impact of current and expected nearby retail competition.

In our analysis, Moody's associates will assess a government's local revenue forecasting by looking at historic trends and budgetary assumptions, including comparisons of budget-to-actual results on a line item basis for the major revenues and expenditures, usually over several years. The strongest management teams have a solid track record of meeting projections in most line items over several years. We also analyze the assumptions behind the current and upcoming years' budgets, to see if we believe the government is likely to reach its targets in the future.

Overall, our reason for focusing on this analytical area is that rosy revenue budgeting can lead to shortfalls within a fiscal year. These shortfalls must then be filled, either by last-minute revenue enhancements, expenditure cuts, one-shots or draws into reserves. All of these measures undermine future financial flexibility, which can create fiscal problems in subsequent years and pose a significant challenge to credit strength.

Tight Expenditure Controls

Similarly to our analysis of revenue growth, Moody's analysts will also look for strong management by assessing the government's track record of expenditure controls and conservative but reasonable expenditure projections. In Moody's view, the strongest management teams are able to discuss the levels of flexibility within each expenditure line item as well as discuss the details about the assumptions behind their budgeting. We bring to these expectations a sensitivity to political realities and to the extremely difficult balancing act that government officials must perform between providing services and controlling costs. As with the revenue side, we consider tight expenditure controls part of strong management because such controls lessen the likelihood of fiscal distress, within a fiscal year and beyond.

Further, in times of economic weakening, revenues such as sales tax and income tax are likely to stagnate or even decline, and property tax collection rates may fall. Therefore, expenditure controls are key to keeping a budget balanced. Otherwise, over-budget expenditures are usually paid through draws from reserves, cash borrowing or one-shot revenues like asset sales. Using any of these approaches weakens the government's options the following fiscal year, when the continued expenditure growth could cause further fiscal distress.

Multi-Year Budget Planning

Because the results of one fiscal year of course impact the next fiscal year, Moody's recommends that governments implement multi-year fiscal planning. Generally done over three- to five-year timeframes – although sometimes up to 10 years – these long-term plans show the level of revenue growth necessary to reach particular spending levels and, alternatively, the impact that slowed revenues would have on spending. By plugging in various economic assumptions, government officials can use these plans to envision their budgetary needs over the near- to medium-term. Officials can "stress test" certain revenue streams – for instance, possibly learning that level state aid funding could be offset by the expected property tax revenue growth, allowing for normal expenditure growth even during a state's fiscal crisis.

Moody's has found that these documents serve as helpful planning tools, allowing officials to communicate "from the same page." Fiscal plans are also helpful to our analysis, since they can lay out in black and white the arguments for how a government, in times of economic constriction or other challenges, plans to maintain financial stability. They can put numbers behind an argument that a worse-case scenario is still not a scenario of lowered credit strength.

The best fiscal plans are incorporated with long-term capital planning, identifying future debt service costs and additional operational costs that will result from new capital construction. These types of integrated plans demonstrate how the government will pay for increased services and inflationary budget growth. They identify areas of potential financial flexibility – for example, capital spending that could be reduced or fees that could be increased. In short, multi-year fiscal plans perform two important functions: one, they walk the reader through the "what if" questions with quantified, hard answers; and, two, they provide a road map that shows where the government's management team intends to go over the next several years.

2. FUND BALANCE POLICIES

Moody's analysts realize that many municipalities have experienced sustained expenditure pressure primarily driven by incremental salary costs, health insurance premiums and pension payments. As a result, in the last few years many municipalities have appropriated some of their reserves for operations. While Moody's understands these pressures, we also want to see adequate levels of generally available, highly liquid fund balances maintained, even in an environment of fiscal strain. Fund balance policies provide one of the best guarantees to bondholders that sufficient levels of fund balance will be maintained, regardless of economic cycles, cash crunches or administrative turn-over.

Maintaining adequate reserves has several internal and external benefits. Internally, reserves can provide for cash flow needs until major revenues are received, reducing or eliminating the need for cash flow borrowing; provide funds to leverage state or federal grants; and provide for the unexpected. Externally, reserves tend to be viewed favorably by investors, rating agencies and local banks with which a municipality does business, thus benefiting ratings and decreasing the potential need for external liquidity sources.

A municipality's fiscal policies should incorporate a plan related to reserves, specifically when they can be used, what the fund balance target level is and to what minimum level they will not drop below. We also prefer fiscal policies that define a target for cash as well as fund balances, as cash is a leading indicator of financial health. Moody's does not require specific fund balance levels, but one guideline is undesignated reserves that equal one to two months of operating expenses or between 5% to 10% of annual revenues. The specific targeted level should be predicated on the level of fiscal vulnerability faced by the particular government, including the cyclical vulnerability of the revenue stream, volatility of expenditure items and likelihood of natural disasters. A town located in a flood zone with a high reliance on sales taxes, for example, should have relatively high fund balances to hedge against the relative risk in its operations. Also, a county that is reliant on economically sensitive revenue streams such as sales or income taxes and is experiencing growing social service costs should also have higher reserves. The bottom line is that General Fund balances should be sufficient to address normal contingencies and maintain stability in reserves over time. This is always the case, and it is certainly important in smoothing the transition phase from a robust to weaker economy.

Moody's also prefers to see written investment and fund balance policies, and ideally those that have been adopted by the government in some formalized manner, such as a resolution. A written policy, while not necessarily legally binding, indicates to Moody's that the government officials have discussed the policy in full and arrived at a consensus behind it. In short, we believe written policies carry much more weight than verbal agreements do. For more information on Moody's view of fund balances, please refer to our special comment "Your General Fund Balance – One Size Does Not Fit All!"

3. DEBT PLANNING

As with fund balance policies, formalized debt planning and debt policies provide bondholders with reassurances that debt burdens and operational debt costs will be kept at manageable levels and that, simultaneously, capital needs will be met on an ongoing basis.

The debt burden measures how leveraged a community is by calculating the amount of debt outstanding as compared to the entity's full valuation. Ultimately, the more leveraged a tax base is, the more difficult it is to afford additional debt. Moody's views debt burdens that range from 3 to 4% as average, although this range varies somewhat by state. Therefore, in debt policies, Moody's prefers to see maximum debt burdens above which the community will not bond, identified as a percentage of the community's full valuation and also, possibly, as a per capita percentage. The best debt policies include both a target debt level, say, 2.5%, and a maximum debt level, for example, 4%, and then project the community's next five year's of capital borrowing against those levels. Also, if an entity plans to enter into an interest rate swap, Moody's believes that it is important to incorporate swap objectives into the debt policy. In our analysis of swap deals and their potential impact on credit quality, one of Moody's analysts' main concerns is the exposure of that issuer to the effects of interest rate volatility of variable rate interest. Therefore, we regard strong management teams as those that understand the purpose of the swap transaction and the risks inherent in the transaction. For more information on swaps, please refer to Moody's special report entitled "Swaps and the Municipal Market: The Impact of Swaps and FASB 133 on Municipal Credit Quality."

Existence of a regularly updated, multi-year capital improvement plan is critical to good management, as such plans itemize the future capital needs of the government and identify financing sources for each of the upcoming capital projects. The strongest governmental management teams then incorporate their capital improvement plans into their debt projections and multi-year fiscal projections – identifying how both their debt and operating capital expenditures will impact their balance sheets and financial operations.

On the operating side, Moody's recommends that – in addition to debt policies – management teams adopt policies for their pay-as-you-go financing of capital work and the percentage they believe debt service should represent of their overall expenditures. For instance, some governments have policies that ensure that 5% of building permit fees, impact fees or other earmarked revenues are diverted annually into pay-go capital spending. Others have policies that state that half of any annual operating surplus will be used for pay-go capital spending. The particular policy adopted should be determined by the needs of that individual government and can be honed by looking at peer group norms. Similarly, Moody's prefers to see policies that identify a maximum that debt service should comprise of total operating expenditures. Debt service payments represent a fixed expense and as such, they offer limited line-item flexibility should financial operations become stressed. The typical range for debt service as a percent of expenditures is 5 to 15%. Moody's recommends debt service policies that incorporate the near-term and long-term capital needs of the community and result in feasible, financially responsible goals for that community. For more information on Moody's analysis of debt, please refer to our special comment "Moody's Approach to Analyzing Municipal Long-Term Debt."

4. CONTINGENCY AND SUCCESSION PLANNING

Contingency planning is critical to good governmental management, and should be part of the management strategies we discuss throughout this report. Long-term budgeting, for instance, involves contingency planning because it depends on managers being able to quickly identify unexpected mid-year changes in their revenues or expenses and respond immediately, usually according to previously outlined plans. Fund balance policies, as discussed above, also serve as contingency plans, as they work best when they are adopted documents that continue to influence financial decisions even when the appointed and elected officials behind the policy change.

Similarly, changes in a government's management team should not jeopardize that government's credit strength. Moody's analysts should be given an outline of a government's organizational structure, including which department heads answer to whom, and whether certain department heads who are key to credit stability – namely, treasurer, finance director, business administrator and/or comptroller – have deputies with significant responsibilities. These questions help our analysts assess whether the government would continue to function smoothly if an individual member of the management team were to leave. Any further documentation on likely staff movement, such as a written succession plan, is also helpful. This issue is of particular importance if the government has appropriation, swap and/or variable rate debt outstanding, because in those cases the manager's ability and authority to act quickly on debt service budgeting requirements, payment due dates and puts is essential.

Other credit-risk scenarios that highlight the importance of contingency planning are: annexation proposals, voter referenda that could impact financial operations, and major tax appeals. In these three examples, the change is rarely a surprise; discussion of the burgeoning problem almost always takes place first. With any government that is facing one of these issues, Moody's analysts would want to be informed of the possibility beforehand and discuss in detail the government's plans for all possible outcomes. These discussions can be kept confidential and do not have to occur in conjunction with a bond sale. Moody's analysts are less concerned with what the particular challenge is and more concerned with seeing foresight and proactive planning by the government officials in response to it.

5. STRATEGIC PLANNING FOR ECONOMIC DEVELOPMENT

The economic viability of a locality drives its ability to generate adequate financial resources to meet operating and debt service needs. Because of this, Moody's believes that the strongest management teams are involved in targeted economic development initiatives that can influence the future vitality of their particular entity, mainly over the long-term.

In our analysis, Moody's considers the local government's economic size, its growth and redevelopment potential, government management of economic development, the size of the tax base, tax base diversity and concentration, whether there are unmet workforce issues, demographic measures, and likely growth trends. We want to see economic development strategies that suit that government's particular strengths and weaknesses and economic development staff members that have an accurate sense of the community, its needs and how they will achieve their office's economic goals. These goals should be consistent with the size and complexity of the particular tax base. For example, a small community with stable employers may warrant a small economic development staff, while a large city with, for example, a dependence on one industrial sector, may need a larger, more experienced staff able to deal with the challenges it could face.

In the case of economic development incentives, Moody's believes that strong managers use well-considered guidelines for the expected return on investment. Many well-run communities have economic incentive policies that state that a proposed development project may only be considered for an incentive if it is projected to return 100% of the investment or guarantee a certain number of jobs within a set timeframe, for instance, three years. The methodology used to project this return is also outlined in these policies. Moody's further recommends that management teams consider how the use of financial incentives, tax abatements or other economic development mechanisms impact financial flexibility and whether there is the potential for long-term benefit, either through the creation of new jobs of generation of new revenue. For more information on how economic development plans factor into ratings, please refer to Moody's special comment "How Moody's Examines Economic Conditions As a Factor In Local Government Credit Analysis."

6. TIMELY DISCLOSURE

As Moody's analysts depend entirely on the documents and information provided to us by government issuers and their representatives, full and timely disclosure of financial matters is of essential importance to us and is a basic tenet of a well-functioning capital market system. Our analysts are not accountants who prepare the numbers or auditors who opine on the compliance of the reports. Instead, we rely on the information given to us to be accurate and complete. Therefore, in our view, the strongest management teams have audited or reviewed financial reports prepared annually, generally within six to nine months of the close of the fiscal year. The financial statements that are attested to by an outside firm – as opposed to preliminary documents prepared by members of the government's finance department – will be viewed as significantly enhanced. Moody's does not require or even expect all governments to employ national accounting firms, but we do recommend that even small governments employ a respected, established local, regional or national firm. To note, Moody's does rate the debt of issuers that do not publish annual audits (usually, small communities). However, we generally consider those issuers to have weaker financial reporting practices and therefore weaker management as related to disclosure.

The Governmental Accounting Standards Bureau (GASB) creates the accounting principles by which governmental accountants prepare their audited financial statements. Moody's is not the regulatory body behind GASB and, as such, we do not demand compliance with GASB standards. At the same time, we do believe that the strongest governmental management teams comply with GASB (assuming that is the norm in their state, with New Jersey's statutory accounting standard as one of several notable exceptions). This belief is based on our knowledge that GASB has become the industry standard. Additionally, GASB's commitment to being responsive to the needs of the entire affected community and adherence to a due process that gives interested parties ample opportunity to make their views known has resulted in the creation of a time-tested method for establishing accounting standards. Moody's recognizes that this process can become politically and emotionally charged; however, our overall interest in audited documents is in comparability of information and an accurate representation of the issuer's financial picture.

The other sign of strong management is timely disclosure of events that may have a material impact on credit quality. Moody's analysts are frequently contacted by government representatives – outside of any bond sale calendar – who want to inform our analysts of events taking place in their communities. Moody's encourages such communication. These types of informal notifications most frequently involve possible upcoming lawsuits, company closings or bankruptcies, referendum votes, and the like, but they can also serve as a way to keep us abreast of less dramatic events such as the unfolding of ongoing budget matters. Moody's analysts strongly prefer not to be surprised by events that might impact credit quality, and informal communication from the appropriate government official is a recommended way to avoid such surprises.

Conclusion: Why Strong Management Matters

Strong management refers to Moody's preference in seeing administrative strategies that improve credit strength in good times and provide strong assurances of maintaining credit strength in weaker times. Indications of credit strength include strategies to ensure that financial practices, debt management, contingency planning and economic development will serve the community well for the both short- and long-term. Strong management also means establishing reserve policy goals and financial and debt benchmarks. These policies additionally guarantee against the concern that a possible change in the government's politics or members will impact its financial operations. They create a baseline for future management teams and, if formally adopted, demonstrate "buy-in" by all affected parties.

Moody's prefers to see that management strategies will help ensure that financial practices are appropriate and responsive to the municipality's needs. We look for debt practices that are thoughtfully structured and in line with statutory and voter prescribed debt limits. We believe that the best managers are responsive to the demands for services relative to the needs of business and residential taxpayers, and have well thought-out contingency plans in place.

Many of the red flags of declining credit strength stem directly from weak budgeting. They include: revenue shortfalls, unanticipated expenditure growth, draws from reserves for operations, and short-term borrowing for operations. For these reasons, we believe overly optimistic budgets pose a greater risk to municipal credit worth than does a slowdown in economic activity. As Wade S. Smith wrote in his book *The Appraisal of Municipal Credit Risk*, "Economic recessions are in a sense disasters, but neither their arrival nor their impact on state revenues come unexpectedly." By implementing the steps recommended in this report – good budgeting, adoption of fund balance policies, debt planning, succession and contingency planning, strategic planning for economic development, and timely disclosure – local governments can create a bridge that carries them through near-term challenges without compromising short-term or long-term credit strength.

Related Research

Special Comments:

Your General Fund Balance - One Size Does Not Fit All!, March 2002 (74269)

Moody's Approach To Local Government Financial Analysis , January 2002 (73689)

Municipal Credit Quality Deteriorates Sharply in 2003, Led By State Downgrades, January 2004 (80905)

Swaps And The Municipal Market: The Impace Of Swaps And Fasb 133 on Municipal Credit Quality, October 2002 (76388)

Rating Methodologies:

The Determinants of Credit Quality, May 2002 (75047)

How Moody's Examines Local Government Economic Conditions As A Factor In Its Municipal Credit Analysis, July 2003 (78882)

Moody's Approach To Analyzing Municipal Long-Term Debt, February 2004 (81248)

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